Internal Revenue Service

memorandum

CC:TL-N-7006-91
Br4:RBWeinstock

date: JUN 27 1991

to: District Counsel, [redacted] SE:[redacted]
Attn: Eric Jorgensen

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [redacted]

This is in response to your request for tax litigation advice in the above-captioned case. We have coordinated your request with the Office of the Assistant Chief Counsel (Employee Benefits and Exempt Organizations).

ISSUE

Whether a social club's excess expenses from providing goods and services to nonmembers, which does constitute a profit-motivated activity, can be carried forward to offset nonmember income for subsequent years as a net operating loss under I.R.C. § 441(a), 512(b)(6) and 172.

CONCLUSION

A social club is not entitled to a net operating loss under I.R.C. § 441(a), 512(b)(6) and 172 from providing goods and services to nonmembers where such nonmember activity is not profit-motivated.

FACTS

[redacted] concerned the unrelated business taxable income of an I.R.C. § 501(c)(7) social club. [redacted] (the Club) derived unrelated business income from the sale of food and beverages, nonmember use of the golf course, investment income and gain from the sale of certain excess land. Income from nonmember use of the Club was derived primarily from nonmember outings and amateur tournaments for nonmembers. [redacted].

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The Tax Court held that the [redacted] golf outings, and the nonmember food and beverage sales were "undertakings" which constituted one "activity." The Tax Court thus allowed the losses from the nonmember food and beverage sales and golf outings to offset the income from the [redacted] The Tax Court, following Portland Golf Club v. Commissioner, 110 S. Ct. 2780 (1990), aff'g 876 F.2d 897 (9th Cir. 1989), rev'g. and remanding without opinion T.C. Memo. 1988-76, further held that since the nonmember activity was entered into without an intent to profit, the Club could not offset losses from the nonmember activity against its investment income. Portland Golf Club never reached the issue of whether the nondeductible losses from unrelated trade or business could be carried forward to offset unrelated business taxable income in subsequent taxable years. The issue is presented in the [redacted] case, although it was not addressed in the Tax Court's opinion.

As a result of the opinion in [redacted], a computation under Tax Court Rule 155 is necessary. The Service and the Club agree that the amounts set forth in the statutory notice of deficiency will be the amounts in the decision except for the taxable year ended [redacted]. For the year ended [redacted], the Club had substantial unrelated business taxable income from the [redacted] The Service and the Club disagree as to whether the Club should be allowed to carryover nonmember losses from taxable years as far back as [redacted] to offset the [redacted] income. For the year ending [redacted], the Service's Rule 155 computation shows a deficiency of $[redacted], while the Club's computation produces a deficiency of $[redacted]. Additionally, if the Club is allowed to carry over its losses, it will be able to use excess losses from nonmember activity to offset any income generated by any future [redacted].

ANALYSIS

I.R.C. § 501(a) provides an exemption from federal income taxation for organizations described in I.R.C. § 501(c)(7). I.R.C. § 501(c)(7) describes social clubs "organized for pleasure, recreation, and other nonprofitable purposes, substantially all of the activities of which are for such purposes and no part of the net earnings of which inures to the benefit of any private shareholder."

I.R.C. § 511 imposes a tax on the unrelated business taxable income of an I.R.C. § 501(c)(7) organization.

I.R.C. § 512(a)(3)(A) provides that for certain organizations, including those described in I.R.C. § 501(c)(7), the term "unrelated business taxable income" means, in part, the gross income (excluding any exempt function income), less the deductions allowed by this chapter directly connected with the production of the gross income

(excluding exempt function income), both computed with the modifications provided in paragraphs (6), (10), (11) and (12) of subsection (b).

I.R.C. § 512(a)(3)(B) provides that for purposes of I.R.C. § 512(a)(3)(A), the term "exempt function income" means the gross income from dues, fees, charges or other similar amounts paid by members or their dependents or guests for goods, facilities or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid.

I.R.C. § 512(b)(6) provides, in part, that the net operating loss deduction in section 172 shall be allowed except that the amount of the net operating loss carryback or carryover shall be determined under I.R.C. § 172 without taking into account any amount of income or deduction which is excluded under this part in computing the unrelated business taxable income.

Treas. Reg. § 1.512(b)-1(e)(1) provides, in part:

> The net operating loss deduction provided in section 172 shall be allowed in computing unrelated business taxable income. However, the net operating loss carryback or carryover (from a taxable year for which the taxpayer is subject to the provisions of section 511) shall be determined under section 172 without taking into account any amount of income or deduction which is not included under section 511 in computing unrelated business taxable income. For example, a loss attributable to an unrelated trade or business shall not be diminished by reason of the receipt of dividend income.

I.R.C. § 172(b)(2) provides that the entire amount of the net operating loss for any taxable year shall be carried to the earliest of the taxable years to which (by reason of I.R.C. § 172(b)(1)) such loss may be carried.[1]

In Portland Golf Club v. Commissioner, 110 S. Ct. 2780 (1990), the Supreme Court considered I.R.C. § 512(a)(3) in the context of determining whether a social club was permitted to use losses incurred in sales of food and drink to nonmembers to offset investment income. The Supreme Court determined that an I.R.C. § 501(c)(7) organization could deduct losses incurred in sales to nonmembers only if those sales were motivated by an intent to profit. In reaching this conclusion, the Court looked to the underlying purpose of the statutory scheme for the taxation of social clubs and noted that:

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[1]Since we conclude that the Club may not deduct a net operating loss, we do not reach the issue of which years the losses should be carried. See, section 172(b)(3).

> [S]ocial clubs are exempted from tax not as a means of conferring tax advantages, but as a means of ensuring that the members are not subject to tax disadvantages as a consequence of their decision to pool their resources for the purchase of social or recreational services. The Senate Report accompanying the Tax Reform Act of 1969, 83 Stat. 536, explained that purpose does not justify a tax exemption for income derived from investments....

110 S. Ct. at 2786.

I.R.C. § 441(a) provides that taxable income shall be computed on the basis of the taxpayer's taxable year. I.R.C. §§ 172 and 277(a) are exceptions to the general rule of I.R.C. § 441(a) and allow operating losses to be carried to other taxable years.[2] However, as shown below, neither I.R.C. § 172 nor 277(a) are of assistance to the Club with respect to excess nonmember losses from an activity which was not motivated by an intent to profit.

The Tax Court held that the Club could deduct no excess losses from unrelated business activities (nonmember food and beverage sales and nonmember use of the golf course) against its investment income because the unrelated business activity was carried on without an intent to profit. [redacted] followed Portland Golf Club which limits I.R.C. § 512(a)(3)(A) deductions from unrelated business taxable income to expenses allowable as deductions under chapter 1 of the Internal Revenue Code. In order to be deductible under I.R.C. § 162 (the only applicable provision in chapter 1), the Supreme Court held that expenses may be deducted only if the organization entered into an activity with an intent to profit.

I.R.C. § 512(b)(6) and Treas. Reg. § 1.512(b)-1(e)(1) provide that the net operating loss deduction in I.R.C. § 172 shall be allowed except that the amount of the net operating loss carryback and carryover shall be determined under section 172 without taking into account any amount of deduction which is excluded in computing unrelated business taxable income. Therefore, based on I.R.C. § 512(b)(6) and Treas. Reg. § 1.512(b)-1(e)(1), the excess losses from the nonmember activity which was conducted without a profit motive (i.e., does not reflect losses from taxable "business" income) are excluded in determining the net operating loss carryback or carryover under I.R.C. § 172. As a result, there is no net operating loss.

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[2]Section 277 does not apply because the Club is an exempt entity.

Moreover, the net operating loss deduction for the excess losses from nonmember activity which was entered into without an intent to profit is not permitted under I.R.C. § 172. Treas. Reg. § 1.172-2 provides that a net operating loss is sustained by a corporation in any taxable year if and to the extent that for such year there is an excess of deductions allowed by chapter 1 of the Code over gross income computed thereunder.[3] The deduction for excess losses is not allowed under I.R.C. § 162 (the only applicable provision in chapter 1) for the [redacted] taxable year because the nonmember activity was not carried on with an intent to profit. See, Commissioner v. Groetzinger, 480 U.S. 23 (1987). Therefore, the Club has no net operating loss which it could carry over under I.R.C. § 172 to offset nonmember income for subsequent years.

Finally, disallowance of the excess deductions in computing the net operating loss follows Portland Golf Club. The focus of the Court's opinion was on the receipt by a social club of tax-free interest and other income from sources outside the membership. In those cases, the members would have received an unintended tax advantage by allowing tax-free dollars to be used for their social or pleasure purposes. The underlying purpose for the taxation of social clubs is for the individual to be in "substantially the same position as if he had spent his income on pleasure or recreation (or other benefits) without the intervening separate organization." S. Rep. No. 552, 91st Cong., 1st Sess. p. 71 (1969), 1969-3 C.B. 470. Section 172(d)(4) limits the net operating loss deduction which may be carried over or carried back for noncorporate taxpayers. I.R.C. § 172(d)(4) provides that deductions allowable by chapter 1 of the Code which are not attributable to a taxpayer's trade or business shall be allowed only to the extent of the gross income not derived from such trade or business. Therefore, if the Club were permitted to carry over excess losses from a nonmember activity which was entered into without a profit motive, its members would receive an unintended tax advantage.

SUMMARY

In summary, I.R.C. § 441 requires the Club to compute its taxable income for the year ended [redacted] on the basis of its taxable year. I.R.C. § 512(b)(6), I.R.C. § 172 and Portland Golf Club prohibit the Club from carrying over to subsequent taxable years the excess losses from the nonmember activity which was not entered into with an intent to profit.

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[3]Although Treas. Reg. § 1.172-2 was amended in 1986 by T.D. 8107, the changes do not affect the conclusion for the [redacted] taxable year.

If you have any questions or require further assistance, please contact Ronald Weinstock at 566-3345.

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